DETERMINATION OF EQUITY REQUIREMENTS FOR REA TELEPHONE LOANS

This is a discussion of the method used and factors considered by REA in determining the amount of equity which a borrower of telephone loan funds must provide in order to obtain an REA telephone loan. In establishing the method of determining the amount of equity required, REA recognized that each loan application would have different characteristics in relation to the degree of loan security that would be provided. Therefore, it was necessary to devise a method which would treat each applicant individually and yet on a uniform basis with all other applicants. The method which was devised is based on an evaluation of the characteristics of each application in relation to six factors. These factors which were considered to be of primary importance in relation to loan security are:

1. Character and operating efficiency as bearing on costs and returns, past and prospective.

2. Evidence of widespread user interest in continued service as a basis for a continuity of revenues.

3. Extent of widespread local ownership and control as basis for assuring continued efficient management in interest of community service.

4. Acceptability and probable effectiveness of REA guidance and assistance.

5. Extent to which surplus will be distributed or retained in system.

6. Local economic trends in relation to prospective revenues.

Each of the factors was given a numerical weighting based on its relative importance to loan security. A score sheet was developed by which the loan application could be rated from zero to the maximum weight for each factor depending upon the degree to which it met the requirement of each factor. This score sheet is attached as Appendix A. The loan applicant offering the best characteristics for every security factor would receive the maximum score for each factor giving a total of 42.

Each application is thus rated and the total score obtained. This score is then subtracted from 50 to determine the percentage of equity required since the application with the highest score should have the lowest equity requirement. The minimum permissable equity requirement is 10% although by this procedure 8% would theoretically be possible. The percent equity requirement thus determined is then applied to the estimate of the total value of the applicants' system after the loan has been expended to determine the amount of equity that the applicant must furnish.

The determination of the equity requirement for each loan application is made by the Administrator. In making this determination the Administrator considers the recommendations of a committee established to review the characteristics of each application. This committee is composed of the Assistant Administrator, the Executive Officer and the Telephone Engineer on the Administrator's Staff. It obtains necessary information on the characteristics of each application from the Applications and Loans Division. A special form was developed for this purpose and is attached as Appendix B. The information requested by this form is obtained by the Applications and Loans Division from reports of its field loan appraisers and from the REA engineering staff. These data are independently reviewed and scored by each member of the committee. The scores are then averaged to arrive at the final score contained in the recommendation to the Administrator. It is this final score which the Administrator considers in informing the Applications and Loans Division of the percent of equity which will be required as a condition of the loan.

Although the REA policy and the procedure outlined in the preceeding paragraphs provide that the equity requirement may go as high as 50%, in no case processed to date has this requirement been reached. Of almost two hundred cases reviewed to date the average equity requirement has been 18 percent. The maximum has been 30 percent and the minimum 10 percent.

Once the percentage equity requirement is determined, an analysis is made of the applicants' existing system and financial condition, unless it is a new organization. This involves assigning a value to the existing system for equity purposes. A second committee was appointed by the Administrator to recommend this valuation for his consideration. In this way each applicant is considered on as nearly the same basis as possible. This committee reviews data made available to it such as the description and condition of the applicants' system and the extent to which it can be reused in the new system, the past revenues received from the system, the economic stability of the area and other information affecting the value of existing facilities. It then recommends to the Administrator the value which should be assigned to the system for equity purposes.

If, after considering the value assigned to the existing system, other assets and the liabilities of the applicant, it is found that the applicant still does not have the necessary equity, additional cash equity is required as a condition of the loan. This is normally obtained through such methods as: the sale of stock to present owners or the general public, the issuance of memberships or receipts for equity contributions from subscribers, or combinations of these methods.

Security Factors	Rating Schedule (points) Good	Fair	Poor
1. Character and operating efficiency as bearing on costs and returns, past and prospective.	(10-14)	(5-9)	(0-4)
2. Evidence of widespread user interest in continued service as a basis for a continuity of revenues.	(6-8)	(3-5)	(0-2)
3. Extent of widespread local ownership and control as basis for assuring continued efficient management in interest of community service.	(6-8)	(3-5)	(0-2)
4. Acceptability and probable effectiveness of REA guidance and assistance.	(4-5)	(2-3)	(0-1)
5. Extent to which surplus will be distributed or retained in system.	(3)	(2)	(0-1)
6. Local economic trends in relation to prospective revenues.	(3-4)	(1-2)	(0)
Total points scored.			

Appendix A

COMMENTS OF PUBLIC SERVICE COMMISSIONS RELATING TO EQUITY IN REA LOANS

Comments of the Washington Public Service Commission in its order dated November 30, 1951, relating to the application of the Farmers' Mutual Telephone Company for approval to borrow from REA, included reference to the equity requirement. In discussing the capital structure of the borrower, the Commission noted that after the expenditure of the REA loan the debt ratio (the ratio of the REA loan to the total of the borrower's equity plus the loan) of the borrower would be 78%. It had this to say concerning the debt ratio:

> "A 78% debt ratio is far in excess of the maximum percentage normally considered to be proper for a soundly financed telephone company. However, the Government has made it possible for applicant to borrow, on - 35-year notes, the sum represented by this high ratio at a rate of interest even lower than large companies, such as The Pacific Telephone and Telegraph Company, can borrow money from banks on short-term notes. In fact, Farmers can retire the loan and pay interest on the diminishing balance for less than the interest payments would be on the same amount if borrowed from certain private lending agencies. For these reasons, the financial burden of servicing the high debt ratio in this case is no greater than comparable burden of servicing a lower debt, maturing in less than 35 years, with a higher rate of interest. Consequently, the high pro forma debt ratio of applicant in this case is not as significant a factor as it might be under different circumstances. Furthermore, as the loan is repaid, the outstanding debt will gradually be reduced and the equity in the form of surplus will be increased thereby improving applicant's capital structure."

The Wisconsin Commission has also commented on the high debt ratios involved in REA loans. Excerpts from two of their orders in which these comments were included are attached.

The following is an excerpt from Order and Certificate of Authority of the Public Service Commission of Wisconsin No. 2-SB-456, dated August 10, 1951. This document authorizes Belmont Telephone Company to issue $27,000 par value of common stock:

"It will be noted that the proposal of the company will result in the following security structure and the ratios of each class of security to the total capitalization:

	Amount	Ratio
Common stock	$ 27,000	16.9%
R.E.A. loan	133,000	83.1
Total capitalization	$160,000	100.0%

The above ratio of common stock is low but the Commission's consideration of that low ratio is limited by the provisions of section 184.05 (4) of the statutes, which has been amended, by Chapter 389, laws of 1951."

The following is an excerpt from Findings, Order and Certificate of Authority No. 2-SB-448 of the Public Service Commission of Wisconsin, dated June 28, 1951. This document authorizes Badger Telephone Company, Inc. to issue $9,750 par value of common stock.

"To finance this program, the company proposed to issue, and sell for cash, $9,750 par value of its 4 percent cumulative preferred stock and to borrow the balance from the Rural Electrification Administration of the United States Government. It appears that the R.E.A. has allocated a sufficient amount, not to exceed $151,000 to complete the financing. Thus, if the full amount of $151,000 is borrowed from R.E.A., the proposed capitalization of Badger Telephone Company, Inc., would be as follows:

Table 1

	Amount	Ratio
Common stock-now outstanding	$ 16,500	9.3
Preferred stock-proposed	9,750	5.5
R.E.A. loan-proposed	151,000	85.2
Total capitalization	$177,250	100.00

"However, the Commission must consider the proposed issuance of said debt in judging the reasonableness of the balance of the financial program of the company, for the purpose of determining the "relative amount of financial interest which the various classes of stockholders will have in the corporation * * *." The above table 1 shows that the company's proposal will result in a 9.3 percent ratio of common stock and a 5.5 percent ratio of preferred stock. This ratio of capital stock to total capitalization is low and it is this Commission's opinion that, when such an unusually high debt ratio prevails, reasonable protection to the security holders indicates that no security should be authorized which would rank, in seniority, between that debt and the common stock. This matter was alluded to at the hearing (pages 43 and 45 of the transcript of testimony) and the president of the company indicated that the company planned to issue and sell common stock if there were objections to the proposed preferred stock issue. The order in this proceeding will, therefore, deny authority to issue the preferred stock, and the certificate of authority will authorize the issuance of $9,750 of additional common stock in lieu of a like amount of preferred stock."